

2011 Executive War College

Anatomy of a Deal:
A Legal Overview of the Deal Process,
Key Documents and Common Deal Issues

May 5, 2011

David C. Lowance, Jr.
Alston & Bird LLP
David.Lowance@alston.com

Jennifer Stapleton
McDonald Hopkins LLP
jstapleton@mcdonaldhopkins.com

Objectives

- Describe lifecycle of a transaction
- Highlight key issues often encountered in purchase and sale of pathology practice or laboratory business
- Contrast perspectives of buyer and seller

Lifecycle of a Transaction

- Preparation for sale
 - Buyer preparation
 - Seller preparation
- Courtship
- Letter of intent
- Due diligence
- Acquisition agreement and related documentation
- Preparations for closing
- Closing
- Integration, post-closing payments, and riding into the sunset

Lifecycle of a Transaction

- Preparation for sale – Buyer
 - Strategy
 - How does this target fit acquisition profile?
 - What are key value drivers for buyer?
 - Financial performance of target
 - Complement to existing business lines
 - Reputation of target professionals
 - Financing
 - Cash, stock, debt (contingent or otherwise)
 - Beware stock in private company – Stark and AKS issues

Lifecycle of a Transaction

- Preparation for Sale – Seller
 - Do You Want to Sell?
 - Can you work for someone else?
 - Are you willing to keep an ownership stake in the business after closing?
 - Do you want the old business to survive in any capacity?
 - Tax Planning / Deal Structure
 - Corporate Clean-Up
 - Accounting / Financial
 - Employee Matters
 - Intellectual Property Protection
 - Litigation
 - Licenses
 - Due Diligence of Prospective Buyers
 - Reputation
 - Ability to Close
 - Prospective financial model

Lifecycle of a Transaction

- Courtship
 - Typically, conducted with active assistance of buyer and seller financial advisors
 - Company will be shopped to select or not-so-select group of potential buyers
 - Consider your preferred type of buyer
 - Strategic / Industry
 - Financial
 - Consider use of auction process
 - Key Documents
 - Engagement Letters
 - Confidentiality Agreement
 - Offering Memorandum

Lifecycle of a Transaction

- Letter of Intent
 - Sets forth key terms under which acquisition will be conducted
 - Focus on items that impact deal value: price, valuation methodology, employment terms
 - Address overall deal structure and financing
 - Asset vs. Stock
 - Seller Financing
 - Equity Rollovers
 - Buyer Financing
 - Most terms are non-binding, but important
 - Binding terms: exclusivity, miscellaneous

Lifecycle of a Transaction

- Due Diligence
 - Extensive review of all aspects of target business
 - Primary objectives:
 - Validate model on which purchase price is based
 - Assess areas of potential risk – known and unknown
 - Inform drafting of acquisition agreement
 - Minimize post-closing indemnification risks
 - Assist with planning for integration
 - Will be conducted at least up to date of signing
 - You will become frustrated with the process
 - Identify key employees to help respond
 - Consider use of electronic data rooms

Lifecycle of a Transaction

- Acquisition Agreement – Overview
 - Sets forth terms of purchase and sale
 - Can provide for simultaneous sign and close or signing with deferred closing
 - Allocates risk between parties
 - Deal risk – what must happen for parties to complete deal?
 - Business risk – who bears risk of unforeseen losses, whether arising before or after closing?
 - Tension between what might happen and what everyone hopes will happen

Lifecycle of a Transaction

- Acquisition Agreement – Architecture
 - Purchase Price
 - Representations and Warranties of Buyer and Seller
 - Covenants relating to operation of business, completion of transaction, post-closing obligations
 - Conditions to closing; termination
 - Indemnification

Lifecycle of a Transaction

- Preparations for Closing
 - Acquisition agreement as road map to closing
 - Role of disclosure schedules
 - Third party consents
 - Payors
 - Licensing authorities
 - Landlords
 - Material contractual counterparties
 - Negotiation of key agreements:
 - Employment and Consulting Agreements
 - Transition Services Agreements
 - Non-compete Agreements
 - Seller now operating the business partly for buyer's benefit → related covenants
 - Integration planning

Lifecycle of a Transaction

- Closing
 - Point in time when ownership actually changes
 - Month end closing is preferred
 - Can be done in person or remotely
 - Largely lawyer driven

Lifecycle of a Transaction

- Integration
 - Most happens outside of view of counsel
 - Recommend active and visible involvement of buyer and seller representatives in process
 - Keep in mind that while buyer and seller have been living and breathing the process for months, third parties (including employees) may be learning about it for first time → unsettling

Lifecycle of a Transaction

- Post-Closing Payments
 - Four principal types:
 - Purchase price true-ups (e.g. working capital adjustment)
 - Earn-out payments
 - Indemnification payments
 - Seller notes
 - All have the effect of changing the purchase price

Common Deal Issues

- Deal structure
- Valuation
- Seller financing (seller notes & rollover equity)
- Earn-outs
- Control over operation of business
- Employment/Consulting terms
- Restrictive covenants
- Employee matters
- Indemnification
- Taxes

Common Deal Issues

- Deal structure – Tax Considerations
 - Will address at only a very high level
 - Extent of tax planning will be driven by tax status of target company – C-corporation, LLC/partnership or S-corporation
 - Seller goal: avoid double layer of tax, avoid ordinary income on “hot assets”
 - Buyer goal: achieve basis step up in underlying assets to be able to maximize depreciation deductions

Common Deal Issues

- Deal Structure – Form of Transaction
 - Three principal alternatives
 - Sale of target stock
 - Sale of target assets
 - Merger of target with acquisition subsidiary
 - Stock sale is easiest to accomplish
 - All assets and liabilities are conveyed
 - Minimizes consents from third parties
 - Asset sale provides ability to “cherry pick”

Common Deal Issues

- Deal Structure – Corporate Practice of Medicine
 - Laws in many states prohibit ownership of a professional services organization by a corporation
 - Enforcement of restrictions varies by state
 - Similar economic results can be achieved through contractual arrangements, e.g. management contracts and friendly physician models

Common Deal Issues

- Valuation
 - Not a legal concept but informs everything in transaction
 - Buyer and seller expectations on issues will depend significantly on perception of premium
 - Items in deal agreements will be revised to reflect valuation model – e.g. one-time charge v. recurring
 - Typically negotiated at letter of intent stage before attorneys are extensively involved
 - Can include purchase price adjustments

Common Deal Issues

- Seller Notes
 - Used to bridge gap between seller and buyer price expectation
 - Risk of non-payment
 - Subordination and security concerns
- Equity Rollovers
 - Significant incentive for sellers to continue to produce positive performance
 - Upside and downside risk
 - Tax issues
 - Stockholders agreement (governance, puts, calls, etc.)
 - Tie to employment/consulting agreements
- Earn-outs
 - Used to bridge gap between seller and buyer price expectation
 - Also can be significant incentive for performance post-closing
 - Capital gains and ordinary income treatment
 - Regulatory considerations – Stark and AKS
 - Potential for significant conflict post-closing regarding operation of the business

Common Deal Issues

- Control of Operations
 - Before closing, Buyer will want some visibility and control over operations. Seller will be willing to provide visibility, but must be able to maintain control and operate as business needs arise.
 - After closing, Buyer will expect complete or near complete control over operation of business
 - Can cause expectation problems for sellers

Common Deal Issues

- Employment Terms
 - Professionals can be key driver of the value of the business being acquired
 - Employment terms can also represent significant portion of value for sellers
 - Key terms include: duration, termination triggers (for cause and good reason), duties, vacation, benefits
 - Note that benefits packages likely will change post closing and often are not as generous

Common Deal Issues

- Restrictive Covenants
 - Three main restrictive covenants
 - Non-competition
 - Non-solicitation (customers, employees, referral sources)
 - Confidential information of the business
 - Purchase agreement covenants
 - Will be based on snapshot of business at closing
 - Will run for fixed period of time from closing
 - Employment agreement covenants
 - Will resemble purchase agreement covenants but differ in key respects
 - Will change with changes in business over period of employment
 - Will address exceptions to non-competition/non-solicitation restrictions
 - Outcomes depend on determination of “for cause” and “without cause” terminations

Common Deal Issues

- Employee Matters
 - In addition to seller employment agreements, compensation for employed physicians and others will change as well
 - Prospect of partnership for up-and-coming physicians will disappear – may require additional compensation to offset
 - Diminished control over bonuses

Common Deal Issues

- Indemnification
 - Promise of seller to make buyer whole for:
 - Breaches of representations and warranties
 - Breaches of covenants
 - Anything else agreed to by the parties
 - Promise of buyer to make seller whole for:
 - Breaches of representations and warranties
 - Breaches of covenants
 - Post-closing covenants and operation of the business
 - Is effectively a purchase price adjustment for the business not being in the condition promised
 - Gives teeth to all of the other provisions

Conclusion

- Trust between parties will greatly facilitate completion of transaction
- Counsel's job to consider "what if" scenarios, but keep those issues in perspective
- Counsel and financial advisors there to help achieve important goals for buyer and seller
- Prepare in advance, be ready for bumps in the road, and keep eye on the goal - patience is a virtue